Outlook for Financial Markets

Down, but not out!

"In the middle of every difficulty lies opportunity."
– Einstein

Executive Summary

Fourth quarter earnings season delivers solid results

Strong price reactions to positive announcements suggest sentiment had drifted too low

Slow and steady growth theme for 2019 remains intact

Government shutdown impact more likely political than economic

Earnings season recap

Our positive 2019 market outlook is built on the notion of solid, though slower, U.S. economic growth. While there is certainly no shortage of risks to consider (trade negotiations, government shutdowns, Brexit, etc.), our base case is that the economy will persevere on the back of a strong consumer and continued positive fiscal boost. Against this backdrop, corporate earnings, a primary stock market driver, should also deliver slower growth, but steady results. With the majority of fourth quarter 2018 earnings season now on the books, it is evident that this has indeed been the case. In fact, stock price reaction to earnings has been better than that seen in recent periods, suggesting investor expectations were too low.

Throughout the first three quarters of 2018, a strong economy coupled with 2017 tax law changes propelled earnings higher by over 20% for S&P 500 firms *(Exhibit 1)*. Despite these impressive results, estimates for fourth quarter earnings began to decline since peaking in the July to October time frame. At one point analysts were expecting fourth quarter earnings growth of 20.2%, which was subsequently revised down to a still-respectable 16.2%. Since the mid-January low point, however, estimates have staged a rebound as results came in better than feared *(Exhibit 2)*.

The number of companies reporting earnings per share above analyst estimates this quarter was in line with historical trends at 71%. The average earnings beat came in at 3.3% above estimates, and stock price responses to positive results registered a strong 1.4% average two-day increase. This is well above the 1% reaction seen over the last 5 years. Even companies that missed expectations saw their share value rise an average of 0.2%, versus the typical 2.6% drop. Investor sentiment, it seems, had undeniably fallen too far too fast.

On a sector basis, Energy was a standout as S&P 500 Energy firms registered an average result 17.8% above expectations, smashing through estimates that had been consistently lowered over the past several months. Energy companies are now being managed much more efficiently, allowing for increased production at lower break-even costs, helping mute the impact of the late 2018 oil price decline. Industrial, Consumer Discretionary and Health Care companies also exceeded revenue expectations by at least 1% (with more upside on earnings).

Fourth quarter results also affirmed that consumers remain in a strong position, as

Exhibit 1 » Earnings spiked in early 2018 creating tough comparisons for the next year

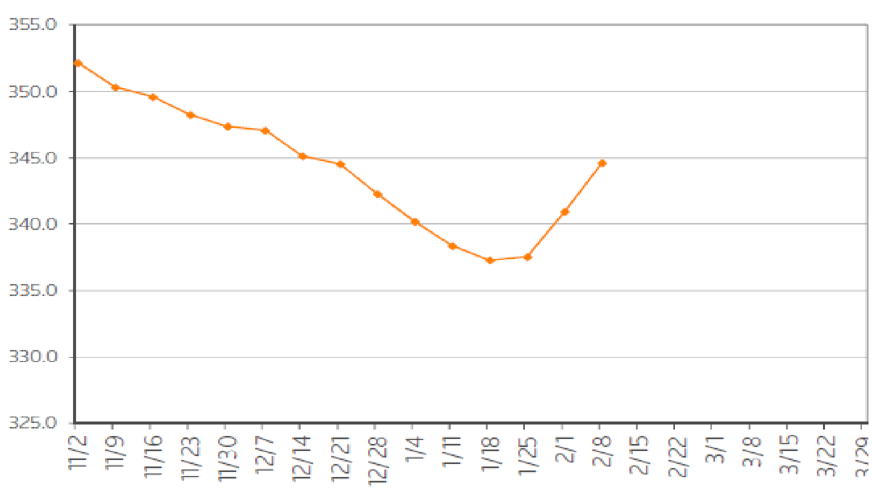
Historical/Current/Future Earnings Growth Rates

						Projection			
Sector	2017Q4	2018Q1	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4
Consumer Discretionary	11.5%	18.8%	21.5%	25.4%	14.5%	-1.4%	7.2%	9.9%	15.5%
Consumer Staples	12.1%	13.1%	13.9%	11.4%	4.1%	0.9%	3.0%	3.8%	6.5%
Energy	120.4%	88.7%	124.0%	114.2%	78.8%	-10.0%	-8.8%	-16.7%	-9.4%
Financials	14.6%	30.7%	27.5%	44.8%	16.9%	4.9%	7.0%	8.1%	19.0%
Health Care	9.1%	16.2%	18.4%	16.5%	12.8%	6.2%	3.4%	5.4%	10.1%
Industrials	1.8%	24.8%	20.2%	18.9%	27.0%	6.0%	9.0%	11.6%	13.3%
Materials	35.9%	39.4%	40.6%	30.1%	2.1%	-11.3%	-5.3%	0.1%	10.2%
Real Estate	-4.1%	3.1%	3.3%	5.3%	6.3%	2.7%	3.3%	4.6%	6.7%
Technology	23.6%	31.8%	29.0%	29.1%	9.2%	-6.0%	-4.7%	-2.5%	7.6%
Communication Services	4.6%	32.1%	26.1%	26.1%	26.0%	-4.2%	18.1%	1.2%	3.2%
Utilities	13.0%	16.4%	10.9%	10.9%	-10.9%	0.7%	2.6%	3.7%	17.6%
S&P 500	14.8%	26.6%	28.4%	28.4%	16.2%	0.1%	3.6%	3.2%	9.8%
S&P 500 Ex-Energy	12.7%	24.5%	25.0%	25.0%	13.6%	0.6%	4.3%	4.5%	11.0%

Source: I/B/E/S data from Refinitiv

Exhibit 2 » Estimate revisions recently began to reverse

S&P 500: Q4 2018 share-weighted earnings ($B)



Source: I/B/E/S data from Refinitiv

sales growth for Consumer Discretionary companies came in at a healthy 5.2% clip. Some positive consumer-related highlights include Starbucks and Disney, with Starbucks' same-store sales growth surging 4% as customers bought more per visit, and 5% higher spending at theme parks contributing to Disney's revenue growth.

In addition to the published financial reports, quarterly conference calls provide valuable insight into current conditions and future trends. They offer both company-specific details, and a bottom-up assessment of the economy. In particular, this quarter we paid close attention to executive comments related to our three big themes for 2019: the Fed/interest rates, Chinese economic growth, and trade/tariffs. On the interest rate front, Citigroup did suggest that fourth quarter rate uncertainty caused some customers to postpone investment decisions, but believes recent Federal Reserve clarity will prevent this hesitation from spilling into a broader economic malaise.

Expected interest rates also drive foreign exchange (FX) rates. Dollar strength was a drag for multinationals in the second half of 2018, and cited as an incremental headwind for 2019. Mondelez, for example, which has around 40% of sales in emerging markets, reported a 1.4% drag on sales due to FX movements in 2018, and expects a negative currency impact of 3% this year. As the Fed is now on hold from raising rates in the near term, the U.S. dollar should stabilize, thereby reducing the currency impact for multinationals. Of course, multinational companies also face the prospect of China's waning growth and a diverse set of firms have confirmed disappointing results in that region. 3M is an example here, where fourth quarter sales were flat in China, which is well below the double-digit growth rates reported in the last few quarters. Recent stimulus measures by the Chinese government should stabilize growth going forward, so we expect marginal improvement on this front later in 2019.

The past few weeks have also brought confirmation that the ongoing tariff negotiations are causing disruptions across multiple industries. Before the holiday, retailers accelerated imports in an attempt to delay tariff costs. More recently, Hyundai's COO for North America stressed the need for resolution so they can complete pending supply chain adjustments, confirming that capital investment decisions are subject to the outcome of trade negotiations.

Looking forward

Earnings growth is expected to decelerate to the low single digits for the next few quarters ***(Exhibit 1)***. A big portion of the slowdown is due to difficult comparisons created by the aforementioned corporate tax cuts. Energy is notable due to its rapid reversal from huge year-over-year earnings gains to projected declines based on lower oil price expectations (which can be volatile and lead to quick reversals). Information Technology company earnings are also expected to dip, given above-average China exposure, a down cycle for semiconductors, and weaker smartphone sales.

For 2019, consensus expectations currently forecast 4.4% earnings growth. While down from 2018 levels, this falls directly in line with our "slow and steady" expectations for the year. On a positive note, the relatively low level of forecasted growth provides an easier hurdle to beat. Furthermore, after the market selloff, the forward P/E ratio for the S&P 500 is at 15.9x, which remains slightly below the 20-year average, allowing room for expansion.

A note on the shutdown

Last month brought to a close the longest shutdown in U.S. government history, and many clients have inquired about its impact. From a purely economic perspective, the episode is likely to have minimal lasting repercussions. Yes, it will shave a few tenths of a percent from Q1 GDP growth, but some of that should be made up for in future quarters as back pay is issued. The more lasting effect will be seen on the political stage. From our perspective, it was always curious that President Trump chose to link a government shutdown to a controversial immigration issue. Shutdowns tend to be universally disliked, and by taking ownership for this one the president handed Democrats negotiating leverage that gave little incentive to compromise.

In the end, facing a possible mass exodus on the issue from his party, the president was forced to throw in the towel. After winning this high-profile battle, Democrats may now feel more confident in future standoffs, which could lead to further gridlock on key budget issues. It is also plausible that President Trump understands his position, and may be willing to more seriously consider compromise on select initiatives. Infrastructure is one area where common ground may be found, suggesting the odds of a deal have gone up. There is also speculation that the shutdown loss will lead the president to seek a quicker win on trade with China. This aligns with his softening rhetoric on the topic over the last few weeks, but any deal that fails to address intellectual property theft and corporate access may not be viewed as a win at all.

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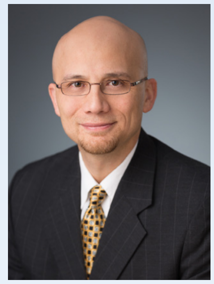
As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments for our Ultra High Net Worth group, and became National Head of Investments in 2015. In January 2018, Michael took over the role of Chief Investment Officer. With close to two decades of experience in money management, Michael has a deep background in economic analysis, portfolio construction and risk management.

Michael earned a BA in economics from Northwestern University and an MBA with distinction in finance and decision sciences from the J.L. Kellogg Graduate School of Management at Northwestern University in Evanston, Illinois. He is a member of the Beta Gamma Sigma International Honor Society, holds a Chartered Financial Analyst designation, and is a member of the CFA Institute, CFA Society of Chicago, and the Chicago Quantitative Alliance. He is also a graduate of the American Bankers Association – National Trust School.



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As Chief Investment Strategist, Yung-Yu is responsible for performing macroeconomic analysis, valuation modeling and market analysis across asset classes to guide strategic and tactical asset allocations for client portfolios.

Prior to joining BMO Wealth Management, Yung-Yu was a finance professor at Lehigh University, where he taught courses in fixed income, equities and derivatives. His academic studies have been cited in the *Wall Street Journal*, in leading finance journals, top law journals, the *Handbook of High Frequency Trading*, and in *Oxford Handbook of Corporate Governance*. During his tenure at Lehigh, he was awarded the Staub Outstanding Teacher Award, awarded to one faculty member by a vote of faculty and students. Prior to his academic career, Yung-Yu worked for a global consulting firm performing financial and market analysis for global companies with operations in Hong Kong, Taiwan and Mainland China. Later, he oversaw the operations at a Fortune 500 subsidiary in Taipei and Mainland China.

Dr. Ma earned his Ph.D. in Finance at the University of Utah and his B.A. in Economics and Political Science, *magna cum laude*, at Williams College.

Yung-Yu lives in Portland, Oregon with his wife and two children. He is a basketball fan and enjoys cheering on his children's teams.

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